

39. These cost allocation ventures are inevitably political, once they go beyond determining and separating out the costs that are clearly causally attributable to the separate services. The reason for this is that they are inescapably circular or tautological: instead of basing prices on objective costs, they distribute costs on the basis of some conception of what sharing of them, in prices, would be “reasonable”—i.e., in accordance with some set of values entertained by the regulator or the public. In short, they distribute costs on the basis of some desired pricing outcome and then purport to set prices on the basis of those costs.²⁰ As the Commission is well aware, the principal use of such allocations historically has been to transfer to long-distance rates and to business customers in central cities a large portion of the costs of providing basic telephone service to residential customers, particularly in rural areas—at the cost of an enormous sacrifice of economic efficiency.²¹

40. That the Commission is still tempted to continue to play this kind of role is clearly suggested by its intention to pass on to telephone subscribers some of the benefits of those joint facilities. It will not lack for pressures to do so, from potential competitors and from consumer advocate intervenors, who tend to think the only interest consumers have is in holding down the price of regulated telephone services, regardless of whether the result is to discourage usage or the offer of unregulated ones, such as cable TV in competition with incumbent cable companies. And of course the telephone companies will be arguing for only a “reasonable” or

²⁰ I have expounded this argument at greater length in “The Uneasy Marriage of Regulation and Competition,” *Telematics*, Vol. 1, No. 5, September, 1984, p. 12.

²¹ See the latest, definitive documentation of this phenomenon in Robert W. Crandall and Leonard Waverman, Talk is Cheap, the Promise of Regulatory Reform in North American Telecommunications, Washington, DC: Brookings Institution, 1996, Chapter 3.

no allocation to the new services. In these circumstances, all history tells us, the Commission will feel obliged to strike a "fair balance" among these conflicting demands.

41. By exactly the same token, any attempt to confer on purchasers of regulated services some of the benefits of the economies of scope achieved by these multi-purpose investments would, the Commission's declaration to the contrary, protect competitors such as cable companies from efficient competition by requiring net additional investments undertaken in order to provide services competitive with theirs to pass a more rigorous test than merely the test of net incremental revenues exceeding net incremental costs.

VI. THE COMMISSION'S ONLY CORRECT COURSE IS TO ABANDON THIS PROCEEDING

42. Any attempt on the part of the Commission, then, to allocate the costs of these common purpose facilities, on any basis other than incremental causal responsibility, will inevitably involve the introduction of political considerations and goals—"equitable" sharing of benefits, a compromise among the demands of the several competitors—into what the new Law laudably dictates be a competitive market process. The NCTA's advice to the Commission to

follow clear cost allocation rules, using a fixed allocation factor for common costs, to minimize the administrative burdens while increasing administrative effectiveness in the face of telecommunications competition (Reply Brief, p. 9)

makes not even a pretense of suggesting application of the criterion of economic efficiency or simulating the competitive market outcome or achieving the explicit purpose of the Act to set in motion market forces that would promote the fullest efficient exploitation of modern telecommunications technology.

43. By the test of a competitive market, a successful product or service innovation is one the revenues and other benefits from which together exceed the full additional costs entailed in offering them. Clearly the undertaking of such innovations would be inefficiently discouraged by any regulatory arrangement that either required the innovators to use some portion of the revenues to reduce rates of existing, regulated services or to recover from those revenues costs that the suppliers would in any event have incurred in order to provide the regulated services.

44. Moreover, if instead the FCC were to attempt to apply the simple, incremental cost principles I have enunciated, undertaking itself to estimate or measure the relevant incremental cost or such benefits as savings in operating and maintenance costs, it would inevitably find itself mired in endless bickering about the proper measures of these essential variables. To offer just a single example:

some LECs have sought to defend the notion that the integrated network would enable substantial reductions in operating and maintenance costs for telephony....however, no detailed basis for this assertion has appeared in the record, to my knowledge, nor is it at all clear that such reductions would occur in comparison with upgrades to existing networks or with new digital loop carriers. (Johnson, Reply, p. 4.)

It takes no imagination to envision the conflicting testimony the Commission would be confronted with on such issues (anticipated in notes 9 and 10, above) as the proportion of the investment costs that would have represented the most efficient way of providing additional capacity for regulated telephone services, both existing and new, or improving the quality or increasing the variety of those services—none of which is properly part of the incremental costs of the new, unregulated services. The process would be a field day for competing engineering, financial and economic expert witnesses. The temptation would be irresistible for the

Commission, as NCTA recommends, "to minimize the administrative burdens" and "increase administrative effectiveness" by adopting some compromise "fixed allocation factor" that would be, in terms of the competitive market norm envisioned by the Act, both arbitrary and wrong.

45. The ultimate irony is that all this administrative managing, with the irresistible temptation it creates for biasing the results of the free market, is unnecessary. The market knows how to encourage efficient investments and discourage inefficient ones. It does so by establishing the two conditions I have already expounded: investors bear the entire additional costs and reap the full benefits; and purchasers of the regulated services bear *none* of those additional costs and receive *none* of the benefit—which requires only that regulatory agencies leave the rates for regulated services, however set, unchanged by these new ventures.

46. How do we establish those necessary conditions? The simple answer is by the Commission *getting out of the way*; leaving the decisions to investors, on the one side, and purchasers of the new services, on the other. This means the Commission should *stop allocating* the costs of these multi-purpose facilities and *not change the prices of regulated services*—up or down—in response to them. *That* is the way to see that purchasers of the regulated services are neither burdened nor benefited by them—which, as we have seen, is another way of saying that this is the way to put on the companies the entire burden of the additional costs to weigh against all the anticipated benefits.²² Neither of these rules leaves any

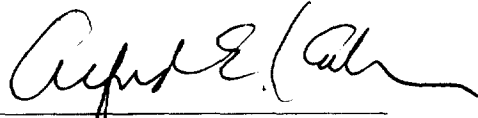
²² To the extent that those benefits include improvement in the quality of existing regulated services or the possibility of offering new ones, investors should be offered a prospect of reasonable compensation for them, when and as they appear. Any attempt by the Commission to go beyond merely offering such an assurance, at this time, and engage in the comprehensive cost allocation signaled in its NPRM would almost certainly do more to discourage efficient investments than to encourage them.

room for cost allocation, and it is high time the Commission gave that practice the indecent burial it deserves. The ultimate message to the Commission is: call off this cost allocation rulemaking and let the market do the job, as the law clearly instructs it to do.

,

I, Alfred E. Kahn, declare upon penalty of perjury under the laws of the United States that the foregoing is true and correct to the best of my knowledge and belief.

Signed

A handwritten signature in cursive script, appearing to read "Alfred E. Kahn", written over a horizontal line.

Alfred E. Kahn

July 19, 1996